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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

FIRST INTERSTATE BANK OF DENVER, N.A.,
Petitioner,

v.

O. F. DUFFIELD,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Does a federal court, exercising diversity jurisdiction, exceed its authority under *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), when it creates a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State?

LIST OF PARTIES

All parties are listed in the caption. Pursuant to Rule 29.1 of the Rules of this Court, the Bank is the wholly owned subsidiary of First Interstate Bancorp; the Bank has no subsidiary that is not wholly owned by the Bank.

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PETITION FOR A WRIT OF CERTIORARI

First Interstate Bank of Denver, N.A. (the "Bank") petitions this Court for a writ of certiorari to review the judgment in this case of the United States Court of Appeals for the Tenth Circuit. This case presents an important question that has divided the federal circuits: whether a federal court sitting in diversity has the authority to make new state law.

OPINIONS AND ORDERS BELOW

The February 1, 1994 order of the Tenth Circuit denying the Bank's petition for rehearing and suggestion for rehearing en banc is unreported and is reproduced at App. 1a. That court's December 23, 1993 opinion is reported at 14 F.3d 1403 and is reproduced at App. 3a.

JURISDICTION

The Tenth Circuit entered judgment in this case on December 23, 1993, and denied the Bank's timely petition for rehearing on February 1, 1994. This petition is being filed within 90 days of the denial of rehearing. This Court has jurisdiction over this case pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. Article III, section 2 of the United States Constitution provides, in pertinent part:

> The judicial Power shall extend to all Cases, in Law and Equity, . . . between citizens of different States . . . .

2. The Tenth Amendment of the United States Constitution provides:

> The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

3. Colo. Rev. Stat. § 4-9-502(1) provides, in pertinent part:

> When so agreed and in any event on default, the secured party is entitled to notify an account debtor . . . to make payment to him . . . .

STATEMENT OF THE CASE

Respondent, O.F. Duffield, a resident of the State of Arkansas, entered a contract with the Bank to secure a loan of $2 million. As collateral for the loan, Duffield agreed to an express, immediate and complete assignment to the Bank of all revenues from his mortgaged oil and gas properties. The contract also expressly provided that the Bank could, upon notice to the purchasers of Duffield's oil and gas, require those revenues be directed to the Bank. Such an agreement is authorized specifically by § 9-502(1) of the Uniform Commercial Code as enacted by Colorado's legislature. Colo. Rev. Stat.

§ 4-9-502(1).[1] The practical significance of such a contractual provision is that it permits a secured party, in its absolute discretion, to collect a revenue stream generated by mortgaged property *in the absence of a default*.[2] The contract between Duffield and the Bank thus gave the Bank the express right to collect revenues from the oil and gas properties wholly independent of its default remedies.

Subsequent to entering the contract, the Bank exercised its unilateral right to collect directly the revenues from Duffield's mortgaged wells. The Bank gave notice to the purchasers and, one day later, to Duffield. The Bank never exercised the separate and independent default remedies provided for elsewhere in the contract.

Duffield filed suit against the Bank in the United States District Court for the District of Colorado, basing jurisdiction on diversity of citizenship. He asserted claims for breach of written and oral contracts and for violation of what he asserted to be a duty of good faith and fair dealing arising under Colorado common law. Although Duffield barely articulated this good faith duty, he apparently believed that it overrode the Bank's contractual right to collect directly revenue from the wells in the absence of any event of default. Duffield thereby asked for a new rule of Colorado law, requiring a

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[1] That statute reads in part as follows:

> When so agreed and in any event on default, the secured party is entitled to notify an account debtor . . . to make payment to him . . . .

The statute, on its face, draws the distinction between having payments directed to the secured party by agreement *or* upon default. A similar provision is contained in the Uniform Commercial Code as enacted in virtually all jurisdictions in the United States.

[2] As a leading commentary on the Uniform Commercial Code explains, "[t]he point to be made is that in these instances the right of direct collection is *not* a remedy on default but a right arising out of the security agreement itself. It is the way the parties to that agreement have structured the financing." T. Quinn, *Uniform Commercial Code Commentary and Digest*, ¶9-502[A], at 9-514 (2d ed. 1991) (emphasis added).

modification or rejection of the rule in Colo. Rev. Stat. § 4-9-502(1). Following trial, the jury awarded Duffield $6,000,000, and the District Court entered judgment accordingly.

The Tenth Circuit affirmed. In its opinion, the court declined to reach the breach of contract issues and, instead, affirmed the judgment solely on the basis of its view of the doctrine of good faith and fair dealing. According to the Tenth Circuit, the Bank could exercise its express right under the contract to collect the revenues directly "only upon a reasonable belief that [Duffield] was in default and only after providing [Duffield] with notice sufficient to allow him to cure those defaults." App. 8a. The Tenth Circuit effectively struck from the contract the express agreement of the parties permitting the Bank to collect the revenues directly in the absence of a default.

The Tenth Circuit thereby established a new good faith rule in Colorado. The court purported to find support for this new rule in three Colorado cases and a prior Tenth Circuit decision, *Big Horn Coal Co. v. Commonwealth Edison Co.*, 852 F.2d 1259 (10th Cir. 1988). In fact, none of the Colorado cases the court cited involved a contract with an express provision that gave one party the unfettered right to take an action subject only to a procedural constraint. *Big Horn* recognized that the concept of good faith becomes irrelevant in the interpretation of a contractual provision that grants "uncontrolled discretion" to one of the parties. 852 F.2d, at 1267. The Tenth Circuit's holding in this case involves not the application of settled law, but an extrapolation of principles of good faith into a realm not previously considered in Colorado: the contradiction of express contractual terms.

The Bank sought rehearing and contended, *inter alia*, that the Tenth Circuit, sitting in diversity, was precluded from affirming the judgment on the basis of its creation of a theory of recovery never adopted (or even considered) by any reported Colorado decision. The Bank contended that, under the principles articulated and applied in *Erie* as well as Article III of the Constitution, it is left to the lawmaking bod-

ies of Colorado, not the federal courts, to create new theories of liability.

The Tenth Circuit denied rehearing on February 1, 1994. On February 14, 1994, the Tenth Circuit denied the Bank's motion for a stay of the mandate. On February 22, 1994, this Court denied the Bank's application for a stay of the mandate pending disposition of the Bank's petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

The Tenth Circuit's decision in this case implicates a split of circuit authority on an issue that federal courts face regularly: Whether a federal court exercising diversity jurisdiction has the authority to make new state law. The rule in the Tenth Circuit, of which the present decision is an example, is that a federal court may create new state law by recognizing a theory of recovery not previously considered in reported decisions of the relevant state court. The First, Third, Fourth, Fifth, Seventh, and District of Columbia Circuits expressly refuse to create new state law under such circumstances, while the Sixth, Eighth, and Ninth Circuits have aligned themselves with the Tenth Circuit on this issue. As the Ninth Circuit has explained: "[T]he rule in other circuits is that the federal courts have limited discretion in a diversity case 'to adopt untested legal theories brought under the rubric of state law.' . . . For better or for worse, this circuit has not seen fit to assume such a posture of restraint when it comes to deciding novel questions of state law." *Torres v. Goodyear Tire & Rubber Co.*, 867 F.2d 1234, 1238 n.1 (9th Cir. 1989) (citations omitted).

The Tenth Circuit's rule is inconsistent with the principles this Court enunciated in *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938). In our federalist system, the authority to create new rights and obligations arising under state law is limited to the lawmaking organs of the sovereign States, and is not assigned to the federal courts sitting in diversity. This Court should grant review in this case and resolve the division of authority among the circuits by reversing the judgment of the Tenth Circuit.

A. The Tenth Circuit's Decision Implicates a Split of Authority on the Important Question Whether Federal Courts Have the Authority to Make New State Law

Federal courts sitting in diversity must apply state substantive law. *Erie*, 304 U.S., at 78. Where there is no state law authority directly on point, a federal court must make the "*Erie* guess"; the federal court must predict how the state supreme court would apply established state law to a new situation. This sort of interstitial decision making is a normal part of the application of any body of law: courts must fill in the gaps based on settled principles when there has been no prior decision addressing the precise issue before the court.

The question this petition presents arises when a federal diversity court is asked not simply to apply settled state law, but to make new state law. The question in such cases is whether a federal court may expand, modify, or revoke settled state law principles, as a state supreme court might do. The question implicates the proper role of the federal courts in our constitutional system, and presently is subject to conflicting answers in the Courts of Appeals.

The rule in at least six Courts of Appeals is that a federal court sitting in diversity may not go so far as to make new state law. These courts hold that such arrogation of state lawmaking authority is inconsistent with principles of federal-state comity and the proper role of the federal courts enunciated in *Erie*. For example, the Fifth Circuit has explained that the power "to make the *Erie*-guess . . . does not enable us to alter existing law or to change direction." *Jackson v. Johns-Manville Sales Corp.*, 781 F.2d 394, 397 (5th Cir.) (en banc), *cert. denied*, 478 U.S. 1022 (1986). This is precisely the rule the Bank advocated, and the Tenth Circuit rejected, in this case.

The First Circuit has cautioned that the job of a federal court sitting in diversity is to apply state law, not to make it:

> Absent some authoritative signal from the legislature or the [state courts], we see no basis for even

> considering the pros and cons of innovative theories . . . . We must apply the law of the forum as we infer it presently to be, not as it might come to be.

Dayton v. Peck, Stow & Wilcox Co., 739 F.2d 690, 694 (1st Cir. 1984). The Third Circuit points to the federalism concerns underlying the rule:

> In a diversity case . . . federal courts may not engage in judicial activism. Federalism concerns require that we permit state courts to decide whether and to what extent they will expand state common law. . . . Our role is to apply the current law of the appropriate jurisdiction, and leave it undisturbed.

City of Philadelphia v. Lead Industries Ass'n, 994 F.2d 112, 123 (3d Cir. 1993) (citations omitted). The Fourth and Seventh Circuits are in accord. *A&E Supply Co. v. Nationwide Mutual Fire Ins. Co.*, 798 F.2d 669, 678 (4th Cir. 1986), *cert. denied*, 479 U.S. 1091 (1987); *Afram Export Corp. v. Metallurgiki Halyps, S.A.*, 772 F.2d 1358, 1370 (7th Cir. 1985).

Perhaps the most complete discussion of the rule the Bank advocates, and its rationale, is set forth in the D.C. Circuit's opinion in *Tidler v. Eli Lilly & Co.*, 851 F.2d 418 (D.C. Cir. 1988). In that case, diversity plaintiffs had attempted unsuccessfully to persuade the federal district court that they could recover under a battery of novel legal theories that had not been recognized by the relevant state courts. On appeal, the plaintiffs renewed their plea. Judge D. H. Ginsburg, writing for himself, then-Judge Ruth Bader Ginsburg and Judge Buckley, explained that it is beyond the role of the federal courts to act as state-law innovators, particularly when the plaintiffs had the choice (as did Duffield in this case) of bringing their claims in state court in the first instance:

> Judicial pioneers must no doubt make bold forays into *terra incognita* in order to chart the way to justice, but that is not the office of a federal court exercising diversity jurisdiction.

. . .

> The plaintiffs in this case . . . are in a particularly poor position to urge such novelty upon a federal court, which by reason of diversity between the parties, exercises only a derivative jurisdiction. The plaintiffs had a choice of where to litigate their claims—in the appropriate state courts or in a federal court. If the relevant state authorities do not indicate any particular receptiveness to innovative theories upon which the plaintiffs' claims vitally depend, plaintiffs' recourse is not to proceed directly to federal court, there to urge the tribunal to adopt such theories because the equities of the case or fundamental notions of justice require that they recover. . . . It is decidedly not the business of the federal courts to alter or augment state law to meet the felt necessities of the case; to suggest otherwise is to ignore fundamental principles of comity inherent in our federal system of government.

Id., at 424, 425.

In the case at bar, an individual plaintiff who suffered considerable personal misfortune unrelated to his contract with the Bank voluntarily brought his claims in federal district court in Denver. In affirming a judgment in favor of the plaintiff, the Tenth Circuit grasped a theory that suited the same "notions of justice" the D.C. Circuit rejected as a basis for federal court lawmaking in *Tidler*. In the D.C. Circuit, and in at least five other Courts of Appeals, Duffield's good faith claim would not have been seriously entertained, much less sustained.

Duffield prevailed on his novel good faith theory in this case because federal courts in the Tenth Circuit do not feel constrained to apply current state law. Rather, these courts may attempt to divine how a state supreme court might rule on a novel theory on the basis of "doctrinal trends indicated by . . . policies" the federal court may glean from state decisions and other sources. *Weiss v. United States*, 787 F.2d 518, 525 (10th Cir. 1986). See also *Lutz Farms v.*

Asgrow Seed Co., 948 F.2d 638, 641 (10th Cir. 1991) (espousing the rule that federal courts must in all cases attempt to decide state-law issues precisely as state courts, unfettered by the constraints of federalism, might decide such issues). The Tenth Circuit in this case speculated that the Colorado Supreme Court would expand the conception of good faith to the realm of matters covered by express contractual terms.

Aligned with the Tenth Circuit, courts in the Sixth, Eighth, and Ninth Circuits have embraced the notion that federal courts sitting in diversity may adopt a novel theory of recovery never considered by the relevant state courts. Like the Tenth Circuit in *Lutz*, the Ninth Circuit has declared itself an arbiter of state law with lawmaking authority equivalent to that of the state courts. *Paul v. Watchtower Bible & Tract Society of New York*, 819 F.2d 875, 879 (9th Cir.), *cert. denied*, 484 U.S. 926 (1987). In *Torres v. Goodyear Tire & Rubber Co.*, 867 F.2d 1234 (9th Cir. 1989), the Ninth Circuit expressly recognized the sharp inter-circuit conflict on this issue:

> We note that the rule in other circuits is that the federal courts have limited discretion in a diversity case "to adopt untested legal theories brought under the rubric of state law." *Affiliated FM Ins. Co.*, 831 F.2d at 155 (7th Cir. 1987). *See also Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 58 S. Ct. 817, 82 L. Ed. 1188 (1938); *Dayton v. Peck, Stow and Wilcox Co.*, 739 F.2d 690, 694-95 (1st Cir. 1984); *Rhynes v. Branick Mfg. Corp.*, 629 F.2d 409, 410 (5th Cir. Unit A 1980). The unwillingness of these courts to speculate on any trends in state law "applies with special force to a plaintiff in a diversity case who has chosen to litigate his state law claim in federal court." *Shaw* v. *Republic Drill Corp.*, 810 F.2d 149, 150 (7th Cir. 1987); *see Afram Export Corp. v. Metallurgiki Halyps, S.A.*, 772 F.2d 1358, 1370 (7th Cir. 1985). For better or for worse, this circuit has not seen fit to assume such a posture of restraint when it comes to deciding novel

> questions of state law. *See Paul v. Watchtower Bible & Trust Society*, 819 F.2d 875, 879 (9th Cir. 1987).

867 F.2d, at 1238 n.1.[3]

In *Johnson v. Honeywell Information Systems, Inc.*, 955 F.2d 409 (6th Cir. 1992), the Sixth Circuit determined that the Michigan Supreme Court would allow a defense to a claim of wrongful termination of employment based upon employee misconduct discovered after the termination. Without any indication from the Michigan Supreme Court that it would allow such a defense, the Sixth Circuit based its "prediction" on an unpublished Michigan intermediate appellate court decision, on "common sense," and on "the dearth of Michigan case law to the contrary." *Id.*, at 413.[4]

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[3] The inter-circuit conflict the court acknowledged in *Torres* may be an intra-circuit conflict as well. In *Brooks v. [illegible] Casinos Inc.*, 959 F.2d 757 (9th Cir.), *cert. denied*, 113 S. Ct. [illegible] (1992), plaintiffs presented a novel Nevada claim of intentional infliction of emotional distress stemming from employment termination. The plaintiffs persuaded the district court that Nevada would recognize the intentional infliction tort in the termination context because the Nevada Supreme Court had recognized it in other contexts. The Ninth Circuit reversed, refusing to recognize plaintiffs' novel theory because the Nevada Supreme Court had given no indication that it would recognize the tort "and the issue is open elsewhere." *Id.*, at 766 (Kozinski, J.). The dissenting member of the panel correctly observed that under *Paul v. Watchtower*, *supra*, the court was "free to decide what it believes the Nevada Supreme Court would hold," 959 F.2d, at 777 (Boochever, J., dissenting).

In this Court, the *Brooks* plaintiffs pointed out that two Nevada federal district court decisions had concluded that Nevada would recognize the intentional infliction tort in employment, and they argued that Judge Kozinski's refusal to predict how that issue would be decided by the Nevada Supreme Court violated *Erie*. *See* Petn. for Cert. in No. 92-215, at 8. The argument was not frivolous, and it illustrates the need for this Court's intervention in the present case.

[4] The appellant in *Woodruff v. Tomlin*, 616 F.2d 924 (6th Cir.), *cert. denied*, 449 U.S. 888 (1980), asked the Sixth Circuit to reverse the district court's conclusion that Tennessee would not recognize a right of action for lawyer malpractice during litigation. The Sixth Circuit did so on nothing more than its conclusion that the intermediate Tennessee appellate decision the district court relied upon did not require the result the district court reached. *Id.*, at 929-30.

Hazen v. Pasley, 768 F.2d 226 (8th Cir. 1985), is a good example of the Eighth Circuit's willingness to make new state law. A diversity plaintiff alleged a right of action arising out of the asserted "wrongful dominion" over his property by Missouri law enforcement officers. In the admitted absence of any Missouri cases on point, the Eighth Circuit concluded that the Missouri Supreme Court would agree with the plaintiff's "public policy" argument and rejected the defendants' contention that any remedy for the wrong alleged by the plaintiff should be addressed by the Missouri legislature. *Id.*, at 228-29. The Eighth Circuit justified its conclusion solely on certain regulatory policies of Missouri law enforcement agencies that appeared consistent with the plaintiff's theory of recovery. *Id.*, at 229. The Eighth Circuit thereby converted an internal regulatory policy into an implied right of action.

The Tenth Circuit's decision in this case is fully consistent with the rule in the Sixth, Eighth, and Ninth Circuits (and is consistent with the rule previously announced in the Tenth Circuit), and contravenes directly the rule in six other Courts of Appeals. The Tenth Circuit here adopted a novel theory of Colorado law—never considered by a Colorado court and inconsistent with the Colorado commercial code—that a good faith obligation may override express contractual terms. The Tenth Circuit purported to find support for this theory in the decisions of Colorado courts, but in none of the cases on which the Tenth Circuit relied did the Colorado courts invoke the doctrine of good faith and fair dealing to nullify express provisions of a contract. Rather, those courts used the good faith doctrine to supply terms found to be implicit in the overall agreement between the parties.[5]

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[5] *See Navajo Freight Lines, Inc. v. Moore*, 463 P.2d 460, 462 (Colo. 1970) (en banc) (a party to a contract may not take advantage of the other party's inability to perform if the former party is the cause of that failure); *Ruff v. Yuma County Transportation Co.*, 690 P.2d 1296, 1298 (Colo. Ct. App. 1984) (purchaser of a transportation route who sought to avoid his promise to purchase by failing to seek government approval had good faith obligation to seek such approval); *Nix v.*

[Footnote continued on following page]

Consistent with settled law, those Colorado cases analyze the doctrine of good faith as "simply a rechristening of fundamental principles of contract law" pursuant to which "an agreement which [does] not recite a particular duty" may nevertheless be found to impose such a duty implicitly if doing so "honor[s] the reasonable expectations" of the parties. *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1152 (D.C. Cir. 1984) (Scalia, J.). As then-Judge Scalia observed in *Tymshare*, contracts may be drafted in such a way as to give uncontrolled discretion to one of the parties to take a particular action, in which case the "reasonable expectations" are defined by the plain language of the contract and the doctrine of good faith is irrelevant. *Id.*, at 1153. The provisions of the contract at issue here gave such uncontrolled discretion to the Bank; those provisions, on their face, fully expressed the intent of the parties.[6] The Tenth Circuit's decision to override those provisions represents a radical expansion of Colorado law that would not be tolerated in at least six other Courts of Appeals.

B. The Tenth Circuit's Rule Regarding the Establishment of New State Law Is Inconsistent With the Principles Established in *Erie*

The sharp division among the circuits on the question presented by this petition arises because federal diversity courts often have difficulty delineating the limits of their authority. On

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[Footnote continued from previous page]

Clary, 640 P.2d 246, 247 (Colo. Ct. App. 1981) (contract to purchase real property implies an obligation on the purchaser to make reasonable efforts toward fulfilling the requirements of the contract pertaining to the manner of payment).

[6] In *Gilmore v. Ute City Mortgage Co.*, 660 F. Supp. 437 (D. Colo. 1986), the district court, applying Colorado law and relying on the analysis of the good faith doctrine in *Tymshare*, rejected the proposition that the implied duty of good faith "take[s] on . . . a life of its own outside the confines of the contract," 660 F. Supp., at 442. In the case at bar, the Tenth Circuit concluded that *Gilmore* was not "an accurate reflection of Colorado law," App. 6a, and gave the good faith doctrine a "life of its own" well outside the plain language of the contract.

the one hand, *Erie* established that federal diversity courts are not to go beyond the bounds of state substantive law. The Court declared that Congress has no constitutional authority "to declare substantive rules of common law applicable in a State," and that "no clause in the Constitution purports to confer such a power upon the federal courts." 304 U.S., at 78. Were Congress to enact a statute authorizing federal courts sitting in diversity to make new state law, such a statute would be unconstitutional under the authority of *Erie*. By the same reasoning, a federal diversity court may not on its own authority alter existing state law:

> A federal court in a diversity case is not free to engraft onto those state rules exceptions or modifications which may commend themselves to the federal court, but which have not commended themselves to the State in which the federal court sits.

Day & Zimmerman, Inc. v. Challoner, 423 U.S. 3, 4 (1975) (per curiam).

A federal court may not "engraft" exceptions or modifications to state law, and *a fortiori* may not create new substantive law that has not already "commended" itself to the State. See *Erie*, 304 U.S., at 71 (rejecting the rule that diversity courts are "free to exercise an independent judgment as to what the common law of the State is—or should be"); *United States v. Standard Oil Co.*, 332 U.S. 301, 313 (1947) ("in the federal scheme our part . . . , and the part of the other federal courts, outside the constitutional area is more modest than that of state courts, particularly in the freedom to create new common-law liabilities, as *Erie R. Co. v. Tompkins* itself witnesses").

On the other hand, federal courts must apply state law in diversity cases even if that law is uncertain. While federal courts may not usurp the authority of state lawmaking bodies, diversity courts have a duty to predict what a state supreme court would do in cases in which there is no state authority on point:

> *Erie R. Co. v. Tompkins, supra*, did not free the federal courts from the duty of deciding questions

> of state law in diversity cases. Instead it placed on them a greater responsibility for determining and applying state laws in all cases within their jurisdiction in which federal law does not govern. Accepting the responsibility, as was its duty, this court has not hesitated to decide questions of state law when necessary for the disposition of a case brought to it for decision, although the highest court of the state had not answered them, the answers were difficult, and the character of the answers which the highest state courts might ultimately give remained uncertain.

Meredith v. City of Winter Haven, 320 U.S. 228, 237 (1943).

Unfortunately, the only guidance this Court gave to the lower federal courts in this regard is that issues of state law are to be decided "with the aid of such light as was afforded by the materials for decision at hand, and in accordance with the applicable principles for determining state law." *Id.*, at 238.

Tension between the obligation to apply state law in uncertain cases and constitutional limitations on federal authority to make state law become acute in the all-too-common cases like that at bar, where a diversity court is asked not simply to make the "*Erie* guess," but to expand state law in a manner not contemplated by the state courts or legislature. Some courts, like the Tenth Circuit, see their *Erie* obligation as only to "stand in the shoes" of the state courts, and feel free to make new state law. Other courts apply state law, but heed also the federalism and comity concerns that *Erie* and our constitutional system impose. These courts refuse to expand state law. Petitioner submits that only the latter rule resolves the tension in a manner consistent with the constitutional limitations that govern the act of a federal court applying state law.

The present case is a good example of the dangers of federal judicial activism in the application of state law. The

Tenth Circuit, in applying its own conception of fairness, has stood on its head a fundamental principle of contract law adopted by virtually every State in enacting the Uniform Commercial Code. It is neither the business, nor particularly within the expertise, of a federal court to engage in the expansion or modification of state law. When federal courts make incorrect predictions about state law, they mislead those who rely on such decisions and may impede the orderly development of state law. See *Burford v. Sun Oil Co.*, 319 U.S. 315, 327 (1943) ("Delay, misunderstanding of local law, and needless federal conflict with the state policy, are the inevitable product of" federal court intrusion into matters of state law). See generally D.K. Sloviter, *A Federal Judge Views Diversity Jurisdiction Through the Lens of Federalism*, 78 Va. L. Rev. 1671, 1676-84 (1992).

The lower federal courts regularly confront the challenge of applying state law to novel claims, and have done so with little guidance from this Court. That these courts are divided on such a fundamental issue as the limitation of their lawmaking authority is intolerable, but perhaps not surprising. This Court's announcement of a general rule in this case would resolve this major split of authority and greatly assist the federal courts in the correctly reasoned disposition of thousands of diversity cases. Federal diversity courts should reject novel claims of state law. Only this bright-line rule, accepted by a majority of the Courts of Appeals, is faithful to the principles of *Erie*.

CONCLUSION

For over fifty years, the federal courts, faced with the practical necessity of deciding thousands of diversity cases in which the content of the governing state substantive law might range from clear to non-existent, have struggled to decide those cases as best they could. The present case affords this Court the opportunity to provide much needed guidance and to resolve a clear split among the circuits. The Court should grant the petition and set this case for plenary

review, and ultimately should reverse the judgment of the Tenth Circuit.

April 12, 1994

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

NO. 92-1077

O. F. DUFFIELD,

Appellee,

v.

FIRST INTERSTATE BANK OF DENVER, N.A.,

Appellant.

Entered February 1, 1994

Appeal from the United States District Court the District of Colorado

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Before SEYMOUR, Chief Judge, McKAY, LOGAN, MOORE, ANDERSON, TACHA, BALDOCK, BRORBY, and KELLY, Circuit Judges, and LEONARD,* District Judge.

ORDER

This matter comes on for consideration of appellant's petition for rehearing and suggestion for rehearing in banc.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision.

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* Honorable Timothy D. Leonard, United States District Judge for the Western District of Oklahoma, sitting by designation.

In accordance with Rule 35(b), Federal Rules of Appellate Procedure, the suggestion for rehearing in banc was transmitted to all of the judges of the court who are in regular active service. No member of the panel and no judge in regular active service on the court having requested that the court be polled on rehearing in banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing in banc is denied.

Judge Ebel did not participate in consideration or disposition of petition for rehearing and suggestion for rehearing in banc.

Entered for the Court
ROBERT L. HOECKER, Clerk

By /s/ Patrick Fisher
Chief Deputy Clerk

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

NO. 92-1077

O. F. DUFFIELD,
Appellee,

v.

FIRST INTERSTATE BANK OF DENVER, N.A.,
Appellant.

Filed December 23, 1993

Appeal from the United States District Court
the District of Colorado

Stephen R. McAllister, Larry L. Simms, Washington, D.C. for appellant.

Robert G. Good, Timothy D. Good, Englewood, Colorado; Philip G. Dufford, Douglas P. Ruegsegger, Terry Jo Epstein, Denver, Colorado, for appellee.

Before McKAY, Chief Judge, SEYMOUR, Circuit Judge, and LEONARD,* District Judge.

I.

In this diversity action, First Interstate Bank of Denver, N.A., (hereinafter "the Bank") appeals a jury's award of $6,000,000 to O. F. Duffield on his breach of contract claims.

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* Honorable Timothy D. Leonard, United States District Judge for the Western District of Oklahoma, sitting by designation.

In 1983, Mr. Duffield borrowed $2,000,000 from the Bank on an unsecured basis. In 1984, Mr. Duffield posted his interest in various gas and oil wells as collateral for the loan pursuant to the terms of a Promissory Note, Mortgage, Deed of Trust, Assignment, Security Agreement and Financing Statement (hereinafter collectively referred to as "the agreement"). Pursuant to the agreement, he was required to pay approximately $41,000 per month in principal and $18,000 per month in interest.

In July of 1985, Mr. Duffield's daughter died and he fell behind in his payments to the Bank. Although the July payment was eventually made, Mr. Duffield became delinquent in his August and September payments as well. During the period when Mr. Duffield was in mourning over the loss of his daughter, Mr. Duffield's office manager, Robert Duppman, managed his business affairs. In September, Robert Duppman contacted the Bank regarding Mr. Duffield's past-due account and informed them that Mr. Duffield had agreed to sell one of his properties (the Long Butte property) held as collateral by the Bank in order to catch up his loan payments. Mr. Duppman was informed by Brian Erickson, a Bank vice president, that the release value of the property was $382,000.

Mr. Duffield argues that in exchange for $460,000, the Bank orally agreed to release the property, catch up the delinquent payments, and prepay a month or two of future payments so Mr. Duffield would not have to concern himself with his business affairs while mourning the loss of his daughter. The Bank contends no agreement to pay arrearages or future payments was ever made.

On September 11, 1985, the Bank applied the entire amount of the $460,000 to principal in inverse order,[1] which had the effect of leaving Mr. Duffield past due in his interest and principal payments. On October 2, 1985, the Bank exercised a right of assignment contained in section 3.1 of the Mortgage by mailing to the operators of Mr. Duffield's wells a

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[1] Inverse order is the term used to describe the practice of applying proceeds from a collateral sale to the back end or last principal payments that will be due on a loan. (Appellant's Br. at 7 n.7.)

request to thereafter send all proceeds directly to the Bank. The following day, the Bank notified Mr. Duffield of its actions and cited as justification various defaults including Mr. Duffield's past-due payments for August, September, and October; a borrowing base deficiency;[2] the breach of Mr. Duffield's representation of warranty as it related to prior liens on the Long Butte property; and Mr. Duffield's failure to provide the Bank with an updated financial statement. The Bank also complained of an alleged misrepresentation by Mr. Duffield regarding the amount he received for the Long Butte property.[3]

In November 1985, the Bank began receiving proceeds from Mr. Duffield's operators. These proceeds were applied to Mr. Duffield's loan pursuant to the terms of the Mortgage. Mr. Duffield soon lost all of his oil and gas interests because of the damage to his credit caused by the Bank's actions. In 1988, the Bank sold Mr. Duffield's note which continues to carry a principal balance of approximately $1,400,000.

In 1990, Mr. Duffield brought this action asserting that the Bank breached an oral contract to apply the proceeds of the Long Butte sale to arrearages and to future payments, breached the notice provisions of the Mortgage by not giving Mr. Duffield advance notice of its intention to exercise its assignment rights, and breached the covenant of good faith and fair dealing. Mr. Duffield claimed the Bank's seizure of his oil runs made it impossible for him to pay the operating expenses of his wells, and that as a result, he lost all of his gas and oil interests. The jury found in Mr. Duffield's favor and awarded $6,000,000. The Bank appeals.

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[2] A borrowing base deficiency occurs when the loan value is less than the outstanding principal due on the loan. The loan value is the maximum dollar amount (usually less than 100% of the estimated market value) a bank will loan on a particular piece of collateral. (Appellant's Br. at 3-4 n.3.)

[3] The Bank argues that Duffield informed them that the purchase price was $460,000 when the price was in fact $750,000.

II.

Because it is dispositive of this appeal, the only issue we need to address is whether the Bank breached an implied covenant of good faith and fair dealing. Mr. Duffield argues that he had a legitimate expectation that the Bank would exercise its rights to the proceeds of his oil fields only upon a reasonable belief that he was in default and only after providing him with notice sufficient to allow him to cure those defaults. Because the Bank did not follow these procedures, he argues, it breached its duty of good faith and fair dealing. The Bank, relying on *Gilmore v. Ute City Mortgage Co.*, 660 F. Supp. 437 (D. Colo. 1986), argues that under Colorado law the duty to act in good faith does not apply to a contract provision that unambiguously defines the duties of the parties, and that the contract unambiguously permitted the Bank's actions. In *Gilmore,* a federal district court, purporting to apply Colorado law, held that the implied duty of good faith and fair dealing cannot override express contractual terms. The court stated that the covenant of fair dealing does not take on a "life of its own outside the confines of the contract and superimpose an additional condition on the operation of [a party's] contractual rights." *Id.* at 442.

Even assuming the contract is unambiguous, we do not believe that the holding in *Gilmore* is an accurate reflection of Colorado law. Indeed, the *Gilmore* opinion cites no authority for its proposition that Colorado law applies the implied covenant of good faith and fair dealing only to ambiguous terms in a contract. We note that Colorado has adopted Article 1, § 203 of the Uniform Commercial Code, which states: "*Every* contract or duty within this title imposes an obligation of good faith in its performance or enforcement." Colo. Rev. Stat. § 4-1-203 (1992) (emphasis added). The Official Comment further states that "[t]he principle involved is that in commercial transactions good faith is required in the performance and enforcement of *all* agreements or duties." Colo. Rev. Stat. § 4-1-203 cmt. (1992) (emphasis added). This provision on its face appears to apply in all situations—including when a contract's express

terms do not limit either party's right to act unreasonably. Also important is the fact that the comment to § 4-1-203 specifically cross-references, *inter alia*, § 4-1-208, which expressly requires good faith with respect to enumerated contract terms that would otherwise permit a party to exercise them at will. *Id.*

Turning to the case law, in several instances Colorado courts have held that even though the express terms of a contractual provision appeared to permit unreasonable actions, the implied duty of good faith and fair dealing limited the parties' ability to act unreasonably in contravention of the other party's reasonable expectations. *See, e.g., Navaho Freight Lines, Inc. v. Moore*, 463 P.2d 460, 461 (Colo. 1970) (where defendant agreed to pay plaintiff a percentage of funds to be collected, an implied duty arose to make a good faith attempt to collect funds); and *Ruff v. Yuma County Transp. Co.*, 690 P.2d 1296, 1298 (Colo. App. 1984) (defendant who promised to purchase a transportation route upon ICC approval breached implied covenant of good faith and fair dealing by not seeking ICC approval). *See also Nix v. Clary*, 640 P.2d 246, 247 (Colo. App. 1981). Thus, we believe that Colorado law required the Bank in this case to exercise its rights to the proceeds and provide notice to Mr. Duffield in accordance with traditional motions of good faith and fair dealing.

This court recently discussed the good faith and fair dealing provision of the U.C.C. at length in *Big Horn Coal Co. v. Commonwealth Edison Co.*, 852 F.2d 1259 (10th Cir. 1988). In *Big Horn*, the court explained that "where a contract provision is exercisable only at some discretion of one of the parties, and expectations are created by the contract, good faith limitations are applicable to protect the non-exercising party from unexpected invocation of the option." *Id.* at 1269 n.15. We believe that this language applies equally to the present case. The option to begin receiving proceeds from Mr. Duffield's collateral could be invoked at the Bank's discretion only. Furthermore, the undisputed facts in this case persuade us that Mr. Duffield had a legitimate expectation that the Bank would exercise its assignment rights in

good faith—that is, only upon a reasonable belief that he was in default and only after providing him with notice sufficient to allow him to cure any defaults. We believe that the proper interpretation of the agreement and its surrounding circumstances mandate the conclusion that the agreed common purpose of the loan and security agreements was to permit Mr. Duffield to repay the loan within its terms through the continued operation of his business.

Several facts lead to this conclusion. The Bank initially loaned Mr. Duffield over two million dollars on an unsecured basis. After later providing collateral, the Mortgage itself contemplated in section 2.7 that Mr. Duffield could continue to sell "severed Hydrocarbons in the ordinary course of [his] business" by excluding such sales from the provision that Mr. Duffield would not otherwise sell mortgaged property without consent. The Bank permitted Mr. Duffield to keep and sell the severed hydrocarbons through October of 1985, creating a reasonable expectation that he could continue to do so absent default. The proceeds from the oil runs were usually sufficient to allow Mr. Duffield to make the loan payments. Finally, as the jury found, Mr. Erickson led Mr. Duffield's agent to believe that the status quo would be maintained if Mr. Duffield sold some collateral and provided the Bank with the proceeds. There was sufficient evidence in the record for the jury to arrive at this conclusion. *See Comcoa, Inc. v. NEC Teles., Inc.*, 931 F.2d 655, 663 (10th Cir. 1991). Mr. Duffield also had other properties that he could have sold or applied as collateral had the Bank allowed him adequate time to cure. All of these facts together lead us to believe that the common purpose of the loan was to allow Mr. Duffield to continue to operate his business and repay the loan within its terms. The Bank created a reasonable expectation in Mr. Duffield that the assignment provision would not be used absent a good reason and an adequate chance to cure so that the basic structure of the loan would not be frustrated. Thus, under both *Big Horn* and Colorado law, the Bank breached an implied covenant of good faith and fair dealing by invoking the assign-

ment provision without reasonable prior notice and without a good faith basis for doing so.

We also hold that the district court did not err in letting stand the jury award for $6,000,000. Under Colorado law, the test for consequential damages for breach of contract is essentially one of foreseeability. *See International Technical Instruments, Inc. v. Engineering Measurements Co.*, 678 P.2d 558, 563 (Colo. App. 1983); *Husband v. Colorado Mountain Cellars*, 1993 Colo. App. LEXIS 171 at *6 (1993); and *Dillingham v. University of Colorado*, 790 P.2d 851, 855 (1989). The evidence is undisputed that the Bank's action of taking over the runs devastated Mr. Duffield's credit and his ability to operate the wells. It is also clear from the testimony of Mr. Erickson on cross-examination that the Bank foresaw the extent of damage that its actions could have on Mr. Duffield's business interests. (Rec. Vol. VI at 881-882.) At trial, Mr. Duffield presented adequate evidence to the jury concerning nexus and causation to justify the jury's decision. He demonstrated that his damages were in the general range of $6,000,000. The jury's award was not so excessive as to shock the judicial conscience or raise inferences that passion, prejudice, corruption, or other improper considerations invaded the trial. *See MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/American Express, Inc.*, 886 F.2d 1249, 1259 (10th Cir. 1989). Thus, the judgment of the jury and the district court must be affirmed.

AFFIRMED.

Supreme Court, U.S.
FILED
MAY 23 1994
OFFICE OF THE CLERK

No. 93-1602

In The

Supreme Court of the United States

October Term, 1993

FIRST INTERSTATE BANK OF DENVER, N.A.,

Petitioner,

vs.

O.F. DUFFIELD,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Before reaching the question of Court authority under *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), the Court must decide the following question:

Did the Court of Appeals "create a new State Law cause of action" as alleged by Petitioner, and is it appropriate for this Court to review the issue?

LIST OF PARTIES

All parties are listed in the caption.

STATUTORY PROVISIONS INVOLVED

Colorado Revised Statutes § 4-1-203 (1992) (Uniform Commercial Code):

> Every contract or duty within this title imposes an obligation of good faith in its performance or enforcement.

STATEMENT OF THE CASE

Petitioner asserts in its *Statement of the Case* that ". . . . Duffield agreed to an express, immediate and complete assignment to the Bank of all revenues from his mortgaged oil and gas properties." (Pet. brief pg. 2). This is incorrect. As noted by the Court of Appeals, Mr. Duffield retained the right to continue to sell severed hydrocarbons in the ordinary course of his business and he did so, making his loan payments to the Bank from the proceeds. (Pet. app. 8a).

Petitioner's *Statement of the Case* asserts that ". . . . the Bank could, upon notice to the purchasers of Duffield's oil and gas, require those revenues be directed to the Bank." (Pet. brief pg. 2). This is misleading. The agreement also required that notice be given to Duffield of the Bank's intent to seize the revenues. (Resp. app. 1a) which it failed to do until *after* the revenues were seized. The late notice was also a factor noted by the Court of Appeals. (Pet. app. 5a).

Petitioner's *Statement of the Case* asserts that Duffield pleaded a claim "for violation of what he asserted to be a duty of good faith and fair dealing arising under Colorado common law". (Pet. brief pg. 3). Duffield also asserted in the complaint a breach of duty of good faith and fair dealing under Colorado statutory law, the Uniform Commercial Code, Colo. Rev. Stat. § 4-1-203 (1992), upon which the Court of Appeals focused much of its attention. (Pet. app. 6a).

SUMMARY OF ARGUMENT

The Court of Appeals diligently and specifically applied existing Colorado common law and statutory law, and did not create a new Rule of Law.

A simple state law issue is being paraded by Petitioner as a question of federal law by characterizing the problem as one concerning the function of federal courts in deciding state law issues. It is an issue never discussed by the court below, nor raised by Petitioner until Petition for Rehearing in order to position Petitioner for a submittal to this Court.

ARGUMENT

Petitioner asserts two basic contentions in its Petition, both of which are fallacious:

1. Colorado Uniform Commercial Code, Colo. Rev. Stat. § 4-9-502(1) was clearly applicable but ignored by the Court of Appeals, and

2. Colorado common law was overridden by the Court of Appeals and replaced by a novel theory.

I.

APPLICATION OF COLORADO STATUTE.

The Court of Appeals specifically focused upon Colo. Rev. Stat. § 4-1-202. "*Every* contract or duty within this title imposes an obligation of good faith in its performance or enforcement." (Emphasis added by Court of Appeals.) (Pet. App. 6a). The Court of Appeals had very good reason for not applying Colo. Rev. Stat. § 4-9-502(1), (here espoused by Petitioner) since it states "*When so agreed* . . . the secured party is entitled to notify an account

debtor . . . to make payment to him . . . ." (emphasis added). The parties agreed that Duffield would first be given notice before any collection action would be taken by the Bank; something the Bank failed to do. (Resp. app. 1a); thus the statute endorsed by Petitioner was inapplicable.

II.

APPLICATION OF COLORADO COMMON LAW.

The Court of Appeals held that Colorado courts have applied the implied duty of good faith and fair dealing even though the terms of a contract appear to permit one party to act unilaterally and unreasonably, if the action taken is in contravention of the other party's reasonable expectations. The court cited three Colorado appellate cases in doing so: (Pet. app. 7a); *Navajo Freight Lines, Inc. v. Moore,* 463 P.2d 460, 461 (Colo. 1970); *Ruff v. Yuma County Transportation Co.,* 690 P.2d 1296, 1298 (Colo. App. 1984); *Nix v. Clary,* 640 P.2d 246, 247 (Colo. App. 1981). The thrust of Petitioner's criticism is that Petitioner pretends to read those appellate cases somewhat differently than the Court of Appeals. This is hardly a sufficient basis for Petitioner to assert that the Court of Appeals has tried to "alter existing law or to change direction" of state law. *Jackson v. Johns-Manville Sales Corp.,* 781 F.2d 394, 397 (5th Cir.) (en banc), *cert. denied,* 478 U.S. 1022 (1986), or to call the Court of Appeals' action an "innovative theory", *Dayton v. Peek, Stow & Wilcox Co.,* 739 F.2d 690, 694 (1st Cir. 1984), nor to insinuate that the Tenth Circuit adopted "untested legal theories brought under the rubric of state law." *Torres v. Goodyear Tire & Rubber Co.,* 867 F.2d 1234, 1238 (9th Cir. 1989).

III.

NOT THE CASE FOR THE BELATED *ERIE* ISSUE.

The Tenth Circuit issued its decision without advocating any particular view about the duty of courts presented with novel issues of state law; it simply construed and applied state law. Only at the petition-for-rehearing stage, when faced with an adverse Tenth Circuit decision, did the Bank try to set the stage for a certiorari petition by making the belated claim it now advances. This Court has long held that federal questions are not preserved for presentation on certiorari where the Petitioner waits until a Petition for Rehearing (before a State Supreme Court) to present the issue, and where the lower court did not expressly decide the question. *Radio Station WOW v. Johnson,* 326 U.S. 120, 128 (1945); *Hanson v. Denckla,* 357 U.S. 235, 243-44 (1958); *Herndon v. Georgia,* 295 U.S. 441, 443 (1935); *American Surety Co. v. Baldwin,* 287 U.S. 156 (1932); *Forbes v. State Council,* 216 U.S. 396 (1910); *Simmerman v. Nebraska,* 116 U.S. 54 (1885).

Not only does the Tenth Circuit opinion not espouse the approach to *Erie* that Petitioner attributes to it, none of the three previous Tenth Circuit opinions cited in the Petition does so either. *See Big Horn Coal Co. v. Commonwealth Edison Co.,* 852 F.2d 1259 (10th Cir. 1988); *Lutz Farms v. Asgrow Seed Co.,* 948 F.2d 638 (10th Cir. 1991); *Weiss v. United States,* 787 F.2d 518 (10th Cir. 1986).

Thus, even assuming that the question presented is worth deciding in some other case, this case is not the proper vehicle; the Court should review a case in which the Court of Appeals had adopted one of the two polar views set forth in the Petition, which would make it unnecessary for the Court to delve into state law as a predicate for deciding that the federal law issue is present.

CONCLUSION

Since the Court of Appeals did not create a new state law cause of action and since this case does not present an *Erie* issue, Petition for Certiorari should be denied.

Respectfully submitted,

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APPENDIX A — AGREEMENT

3.5 Status of Assignment. Notwithstanding the other provisions of this Article, the Trustees or any receiver appointed in judicial proceedings for the enforcement of this instrument shall only have the right to receive directly all of the Hydrocarbons herein assigned and the proceeds therefrom immediately upon written notice of its intention to do so to the Mortgagor and to apply all of said proceeds as provided in Section 3.2 hereof. Upon any sale of the Mortgaged Property or any part thereof pursuant to Article V, the Hydrocarbons thereafter produced from the property so sold, and the proceeds therefrom shall be included in such sale and shall pass to the purchaser free and clear of the assignment contained in this Article.